RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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**LETTER 895** **September 6, 1984**

Aug 24 DJIA 1236.53; PTI 1587; A-D Ratio -20.31
Aug 31 DJIA 1224.38 PTI 1593; A-D Ratio -20.20

**THE MARKET:** Often what the market does NOT do is as important in gauging the trend as what the market does do. Along these lines, let's examine a few important things that the market did not do before and after its August upside explosion.

(1) As noted here many times, the D-J Industrial Average during its 1983-84 descent never broke below the critical halfway (50%) level of the 1982-83 advance. The critical level was 1032. Under Dow's 50% Principle, therefore, the overall situation remained positive.

(2) Following the record-breaking explosion of early-August, the Averages did NOT fall apart in typical post-bear market fashion. A month has passed since the August explosion and the Averages are still fluctuating within a consolidation pattern. The longer the elapsed time following the August explosion without a wash-out on the downside, the better this market will look. In other words, the market has not given back a significant portion of its early-August gains. This is constructive action.

One caveat, however: the lower limits of the current consolidation pattern are 1196.11 for Industrials, 511.38 for Transports. If those lows are jointly broken, then a full correction of the early-August rise will be in order.

(3) The advance-decline ratio (see page 2 chart) has NOT fallen back appreciably since the early-August rally peak. This is constructive action.

(4) Now this is very important: around August 10 the 200-day moving average of the Dow started flattening out (after its long descent). The 200-day MA of the Dow is now climbing slightly (it currently stands at 1182). But the Dow has NOT fallen back below its MA. The LONGER the Dow holds *above* its now rising 200-day MA, the more constructive the situation. This is the first time in eight months that the Dow has held above its RISING MA, and a Dow holding above a rising MA is a Dow in the bullish mode.

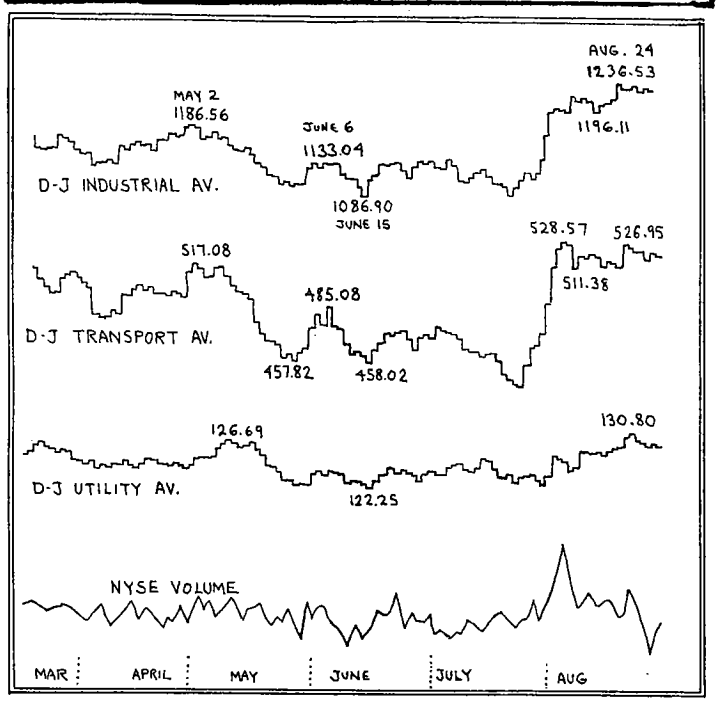
All the above observations are positive, but there is one negative in the list of what the market did not do. On the rise to the highs which saw the D-J close at a peak of 1236.53 (see page 1 chart), the D-J Transports FAILED to confirm. Note that the Transports halted their rally at 526.95 (August 21) roughly two points below their earlier August 6 high. This non-confirmation was the signal for near-term trouble, but how much trouble remains to be seen. Remember, the downside danger points are 1196.11 for the Dow, 511.38 for Transports. BUT, the LONGER that one or both Averages hold above those points, the better this market looks.

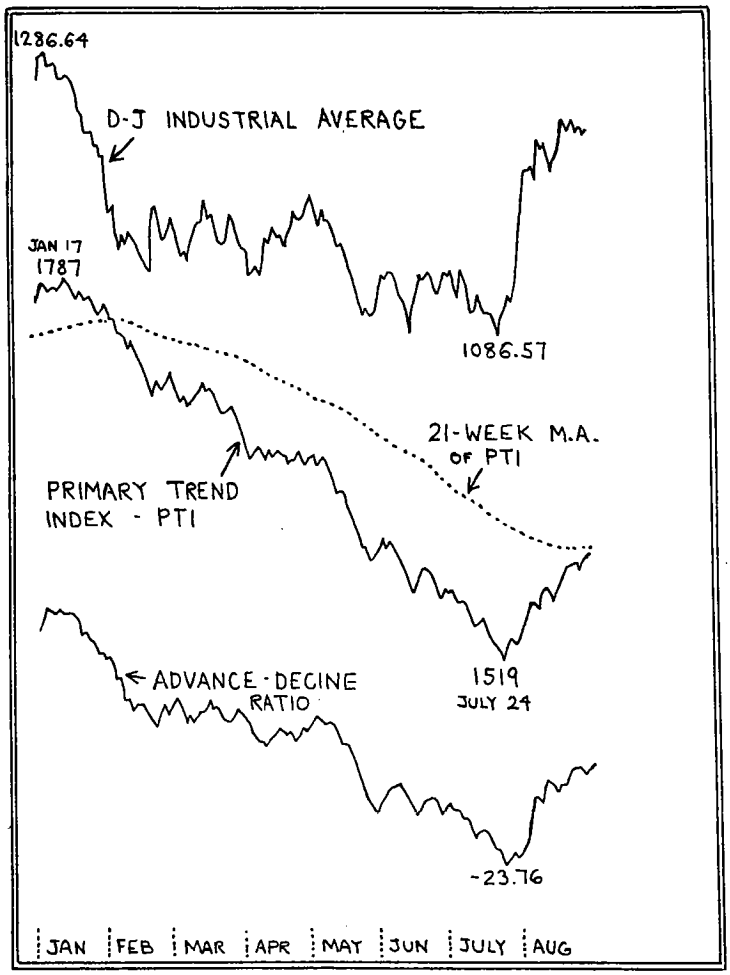
For new subscribers, I might note that the one secret I possess in the market is the construction of my Primary Trend Index. This proprietary indicator is an amalgam of eight different market statistics computed on a daily basis. The eight are all based on market ACTION. The PTI may lead at times, it may be coincident or it may lag a bit, but it will shortly reveal the real underlying direction of the market. My studies indicate that the PTI hit bottom on July 24 at 1519, and we have been in a reversal situation since.

The essence of the PTI is that it tends to measure the build-up of the bullish forces or the gathering strength of the bearish forces. So far, the verdict must go to the bulls. Ever since the July 24 low, the PTI has been pushing upwards, sometimes grudgingly, sometimes forcefully, but even as the market appeared to be backing and filling, the PTI has been edging up to new recovery highs.

Note: one of the prime tests of any market is its action following an initial upside surge. We had the surge in early-August. So far, the market has backed off from its August peaks with little apparent damage. Furthermore, volume has tended to dry up and daily new lows have been minimal as the market has declined. My own guess is that the PTI has seen its low for 1984—as has the general market. If that's true, then in due time we're going higher.

**INVESTMENT POSITION:** I'm still showing that "half a bull" in the box. I think this market acts well, but I would like the PTI to advance ABOVE its 21-week moving average





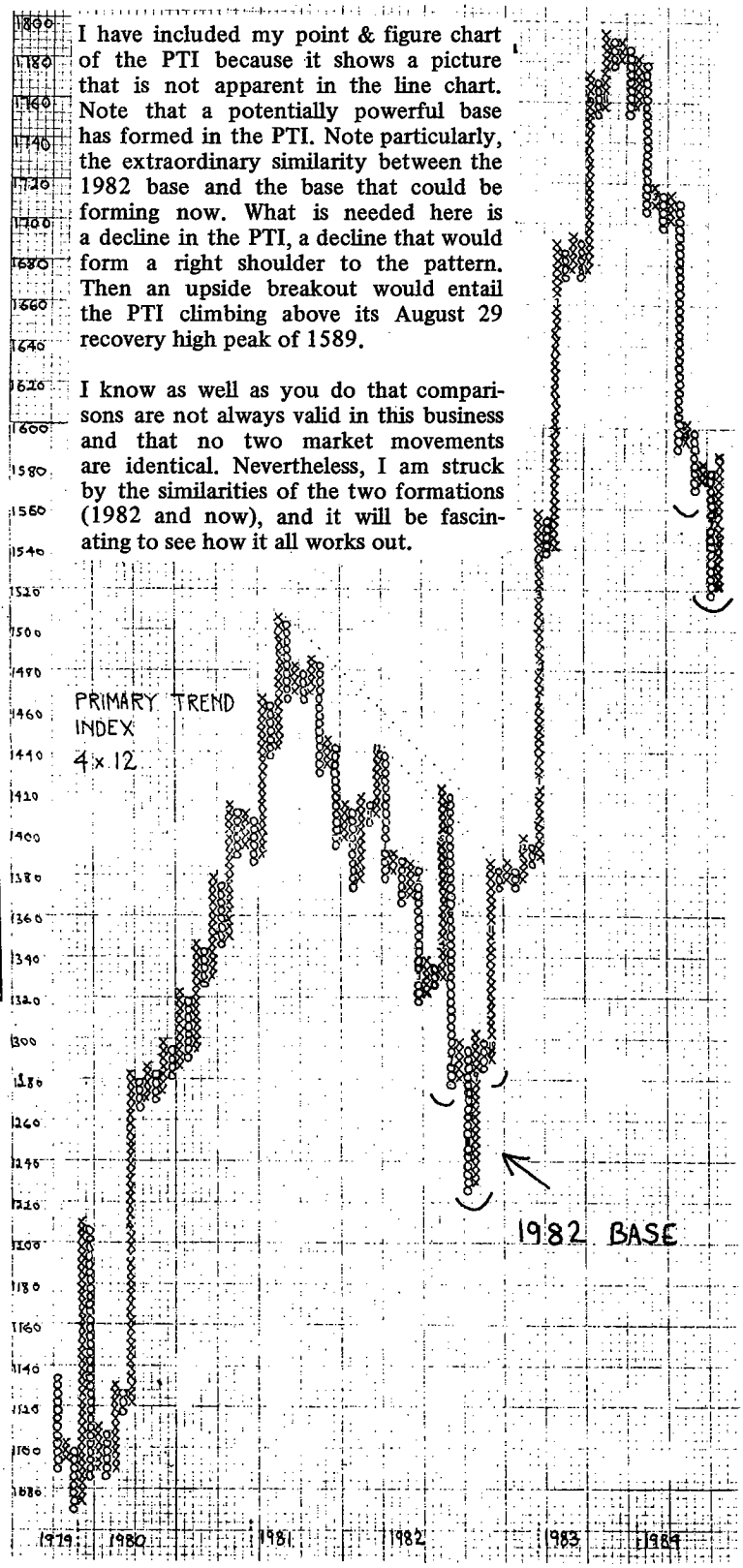

and so far the PTI has stopped just short of it (although I "feel" the PTI is going to push through). Again, I'll say that I don't think there is any big hurry to rush into this market, but partial purchases may be made.

The strongest Dow stocks over the past three months have been (1) United Technologies, (2) Am. Tel., (3) Westinghouse, (4) Amer. Express, (5) IBM, (6) GM, (7) Sears, (8) Owens Illinois. I expect this relative strength to continue.

**QUESTIONS, ANSWERS:** I note that both Joe Granville and Julian Snyder are talking about the current situation as a carbon copy of 1929. What do you think?

*Answer:* I read dozens of investment advisory services each week, and I have a lot of respect for both Snyder and Granville. I note that Snyder has listed a number of parallels linking 1984 and 1929 including (1) an agricultural depression with farmers in very bad straits, (2) huge business debts on top of a thin equity base, (3) a shaky banking system loaded with bad debts, (4) rising protectionism, (5) mountains of international debt, (6) record high margin debts in the stock market.

First, I will note that it is always chancy to bet on an extremely rare event occurring in the stock market. A crash (such as 1929) is a very rare event, and the odds on such a crash occurring at any given time are tenuous.




I have included my point & figure chart of the PTI because it shows a picture that is not apparent in the line chart. Note that a potentially powerful base has formed in the PTI. Note particularly, the extraordinary similarity between the 1982 base and the base that could be forming now. What is needed here is a decline in the PTI, a decline that would form a right shoulder to the pattern. Then an upside breakout would entail the PTI climbing above its August 29 recovery high peak of 1589.

I know as well as you do that comparisons are not always valid in this business and that no two market movements are identical. Nevertheless, I am struck by the similarities of the two formations (1982 and now), and it will be fascinating to see how it all works out.

Next, let me comment that although there are many similarities in 1984 compared with 1929, there are also many differences. One major difference is that people are worried today, worried by the banking system, the debt, the Russians, the possible re-emergence of inflation, etc. Nobody is talking (as they did in 1929) about a "New Era."

And today we have the precedent of 1929, an event that still looms heavy on the minds of anyone who has even passsing knowledge of Wall Street. In 1929 there was no precedent for

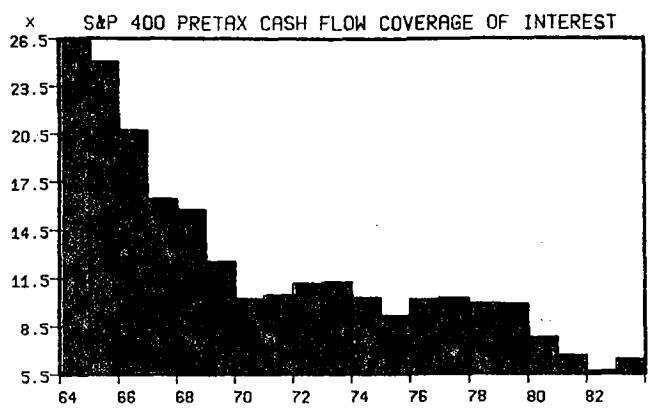
that kind of crash. People didn't think anything like that could occur. The scope of the 1929 crash was unprecedented. Today, widely read advisors like Granville and Snyder warn publicly of "another crash."

My own feeling is that when the next bear market arrives it is going to be a long, tedious, erosion-type of move, a bear market that could take a number of years to complete. I feel that a 1929 kind of crash would be too obvious for today's rather sophisticated investors. A crash would be too obvious a signal that "this is the time to get out, this is 1929 all over again." My bet is that the next really disastrous bear market will be subtler and longer. Investors will be left hoping, and hoping . . . . . and hoping all the way down.

*Question*: Russell, what do you think are the big problems we will be facing over the next few years?

Let me go over a bit of history. In the late-1950's and through the 1960's we had the problem of inflation, and this inflation was basically brought on by the steady increases in the costs of labor. Then in the 1970's the pressure of further rampant inflation was brought on by huge increases in the price of raw materials.

But during the 1980's (and I warned about this for years) the pressure is coming from the cost of carrying the debts, and this pressure has seeped into every corner of the economy from corporations to cities to the federal government to individuals. I feel that from here on the greatest problem facing this country (aside from the Russian arms build-up) will be the cost of handling the debt. This chart (courtesy of Merrill Lynch) shows the




pre-tax cash flow coverage of interest for the S&P 400. Note that the coverage was 26 times in 1964. The coverage dropped to 5.5 times in 1982, and in 1983 the coverage was actually lower than 1981.

As I've noted many times before, during recessions business goes down, employment goes down, interest rates go down and profits go down. But one thing that does NOT go down is the cost of carrying your debt. This is the cost that can break a highly leveraged business during any major economic turndown. So my prediction is that debt management will be the major cost problem of the 1980's and beyond, just as inflation was the cost problem of the 1960's and '70's.

*Question:* I know you read a lot. How much does your reading, particularly in the economic area, help you with your market conclusions?

*Answer:* I read mostly for knowledge, not for market advice or economic pointers. From strictly an investment standpoint, I think the greatest reason for reading economic reports is on a contrary opinion basis. I try to check what I read and what is generally believed with what the market is actually saying. The more the market disagrees with the conventional thinking, the more you can believe what the market is doing and saying.

To provide an example, one of the best economic thinkers in the nation is Francis Kelly, director of research for Oppenheimer. Kelly thinks inflation is now being held back by cheap imports (he estimates that imports may account for 20% of US demand). This import explosion, thinks Kelly, will breed a reaction when it is seen that it is costing a huge number of US jobs. This in turn will lead to a move to keep foreign goods out of the US, prices of US goods will go up, and a recession will begin. (Kelly thinks a sharp recession will begin around the end of 1985.He feels the recession will breed a demand for more jobs, the Fed will spur the economy, and inflation will return.)

Good scenario? Sure, but my own thinking is that I'll watch stocks, I'll watch bonds and gold, and I'll let the market tell me what's going to happen. I'll also let the market do the timing.

To amplify further, after three decades of dealing with markets, I have concluded that most economic and market scenarios are dangerous. A scenario is really a preconceived script on how things will work. Once you've formulated such a script, you find yourself defending that position, and of course, the market would like nothing better than to make a fool of you (and part you from both your money and your script).

If you possess no script, you are more apt to listen to the market itself, and it is my firm conviction that this is the safest position to be in. If you examine the major mistakes of almost any investor or letter writer, you will discover that the mistake was made because the person was trying to prove that his script was correct.

Scripts can grow out of political concepts, economic concepts, various cyclic theories, periodicity theories, seasonal theories, or any of a hundred other theories of technical devices.

My own observations tell me that the only device that has really withstood the test of time is the Dow Theory, based on the action of the Averages and considerations of market phases. The Dow Theory, of course, is subject to various interpretations and many, many mis-readings, but the Theory has been used for three-quarters of a century, and it still has a following today. My guess is that Dow's Theory will be around as long as there are free markets.

*Question*: What do you feel is the critical technical indicator at this time?

*Answer*: The old Wall Street adage states that "the most bullish thing the market can do is go up," and, of course, the action of the Averages (to my mind, as a Dow Theorist), is always the most important technical indication.

However, I have been stressing all year the action of the Dow in relation to Dow's 50% Principle. Thus (see the last Letter) the ability of the Dow to hold above the halfway level of the whole 1982-83 rise (and that halfway level is 1032) was a big technical plus. The lowest the Dow got was the July 24 low of 1086.57, and that was a full 54 points above the critical 1032 level. The ability of the Dow to hold stubbornly above 1032 despite 14

months of decline in the general market was bullish under Dow's 50% Principle. The Dow action told us that in due time the Averages would turn around and test the highs.

On August 3 the Dow did a second very bullish thing. On that day the 200-day moving average of the Dow stood at 1182, but the Dow closed on August 3 at 1202.08. In so doing, it rallied above its 200-day MA for the first time in months.

The test now will be to see whether the Dow can hold stubbornly above its RISING 200-day MA. My own feeling (guess) is that it will. Even such a bear as Joe Granville in a recent report (Aug. 18) notes that the Dow and its position relative to the 200-day MA is important. Joe writes, *"Unless the Dow breaks sharply over the near term as it did in 1973, it will be increasingly difficult to make the bearish case stick. The first order of business required for the bearish case is to take the Dow rapidly under the (200-day) trendline, which currently stands at the 1150 level."*

*Question*: Russell, you have mentioned the action of the averages at length but what else do you see here that would bolster (or tear down) the bullish case being presented by the PTI?

*Answer*: When the Averages are fluctuating between previous primary high points and important lows, it is always difficult to make a definitive bull or bear case. But what I look for is important technical events, events that one wouldn't expect to see "in this kind of market."

Last week the cumulative most-active stock index rallied to a new record high. If this were still a bear market, I would NOT expect to see this basic indicator break out to new record highs.

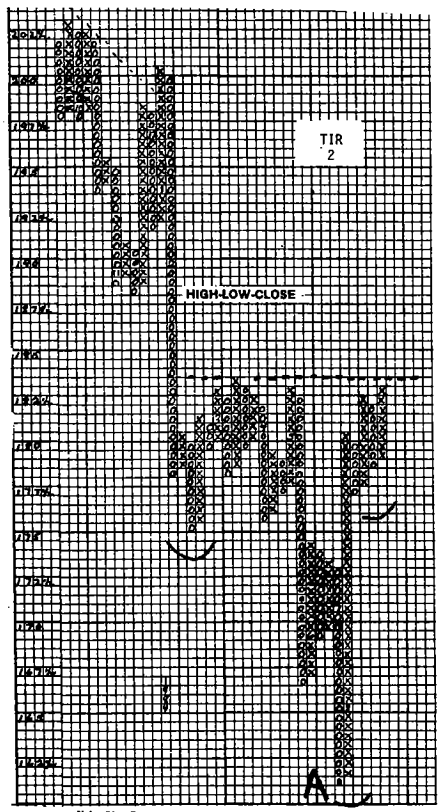
The last reading on the margin account (NYSE) shows a new record high. I would NOT expect to see this in a bear market. During a bear market margins usually skid to new lows as speculators run for the hills.

Last week on-balance volume on the NYSE advanced to new record highs. I would certainly not expect to see this in a continuing bear market.

**INTERESTING INFORMATION:** I usually refer to the Dow, the Standard & Poor's 500 or the NYSE Composite in these reports. But I watch ALL the major Averages, and occasionally I see something that is a bit unusual (it may be bullish or bearish, and it may only show up in a single average).

At this juncture, the broad Value Line Composite (1650 issues on the NYSE, the Amex and over-the-counter) is showing a huge potential head-and-shoulders bottom on the point & figure chart (chart courtesy of Chartcraft, Larchmont, NY). This potential basing pattern particularly interests me because of the extended "tail" or "wipe out" structure which I have marked with an "A" on the chart. When such a deep tail (a severe downward thrust) appears on a bottom structure, it usually means that an upside breakout will have particular force and carry unusually far (the minimum expectation is that the rise from the breakout point will carry at least as far as the tail carried on the downside).

Suffice it to say that it will require a rally to 184 on the Value Line Composite to break this potential bottom pattern out on the upside and thereby turn the Value Line Composite bullish. This could take some time and some doing, but it is a most interesting structure and one worth watching.




Value Line Composite Index — This index is based on the daily closing price until futures trading began. After that it is constructed with daily high-low posting. Each box represents ½ point with 1½ points or 3 boxes necessary for a change in direction. .

Note: of particular interest is the fact that the Value Line is a very broad interest, and if it breaks out topside the implication is that the secondary stocks are going to move up (despite the general current consensus that any rise from here will be strictly blue-chip). Also, note the similarity in what is occurring in the Value Line and the PTI.

**NOTES & QUOTES:** With over 40 wars now going on simultaneously, it is conceivable that the world has grown immune to horror. But the Russian list of atrocities in Afghanistan is moving towards par with the Pol Pot horrors of Cambodia and the Idi Amin annihilations in Uganda. According to Reason magazine, the latest Soviet gambits are small bombs fashioned to look like toys. These are either picked up by parents or children, at which point they explode. Reason shows a photo of a child with no hands, a victim of the new Russian "toys." So horrendous is the Soviet attack on the Afghans that the biggest problem for Russia inside Afghanistan is dope. According to Soviet defectors, half the Soviet army (in Afghanistan) numbs itself on dope.

* *

Soviet casualties mount in Afghanistan, and it is believed that 5,000 Russians have died there while 10,000 have been wounded. But the Russians don't think in terms of casualties, they think in terms of policy and years. Despite the brave stand of thousands of Afghans, the nation of Afghanistan is being slowly bombed, tortured and bludgeoned into the ground. These two paragraphs from the LA Times (August 23) probably say it all.

> The signs of hardening Soviet political resolve and the improved Soviet military position have caused some analysts to reassess their long-term view of the conflict.
>
> They are beginning to think that instead of looking at Afghanistan as a Soviet Vietnam, it might be more accurate to look back to Russia's

experience, early in the century, in taming the old khanates (tribal fiefdoms) of Bukhara and Khiva, which eventually were absorbed.

There, over a period of years, the Kremlin used patience, determination and brutal force to extend its writ farther south into Muslim Asia.

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Commodity speculation (as I have so often warned) can be the ticket to welfare lines. One enterprising Forbes columnist took the semi-annual pick by the experts (the picks of January 1, 1984) and bought a theoretical contract in each pick. Here is the astounding record, a net loss of $21,422 in six months on the experts' picks. But one thing about commodities–it can all happen in a hurry. Where else can you lose this much money this fast?

conclusion. (The following calculations are based on a one-contract position in each market.)

| | Profit | Loss |
|---|---|---|
| **Buy Currencies** | | |
| Sept. D-Mark | — | $1,000 |
| Sept. Swiss | — | 4,100 |
| Sept. Yen | — | 1,562 |
| **Buy Sept. T-Bond** | — | 2,587 |
| **Buy Sept. S&P 500** | — | 8,875 |
| **Sell Aug. Htg. Oil** | — | 1,029 |
| **Buy Aug. Soybeans** | — | 2,650 |
| **Buy Sept. Silver** | — | 3,250 |
| **Buy Aug. Hogs** | $981 | — |
| **Sell Aug. Soybeans** | 2,650 | — |
| | $3,631 | $25,053 |

* *

Stress. . . . is a subject that one reads more and more about today. My belief is that in the future stress will be seen as one of the top killers of modern man. I recently read a piece by a leading physician and stress expert. He stated that he had had a heart attack himself, and he developed the following philosophy to deal with his own stress. Here is his credo: (1) I only worry about the big items. (2) There ARE NO big items.

* *

When I wrote in the last Letter about my daughter, Betsy Russell, I did not realize the amount of interest this would stir up. I received a few dozen letters asking what this Russell creation looked like. Here she is, and she turned 21(a Fibonacci number) on September 6. She has three movies coming out in January.

What are the sizes of the developing countries' loans, and how big are American banks into those loans? Here's the story. The question: how large are each banks' reserves for bad debts? According to E. F. Hutton, the strongest banks are Citibank, Bankers Trust and Morgan because of a growing consumer base and new innovations. Morgan and Bankers Trust also rank high because of conservatism and high reserves.

**Big bank loans to six troubled developing countries***

*Mexico, Brazil, Venezuela, Argentina, Philippines, Chile; as of April '84

| Bank | Six-country total | As percent of total loans |
|---|---|---|
| | Loans in millions | |
| BankAmerica | $ 7,800 | 9.4% |
| Citicorp | 12,500 | 13.0 |
| Chase Manhattan | 7,425 | 13.1 |
| Manufacturers Hanover | 7,825 | 15.8 |
| J. P. Morgan | 4,925 | 14.2 |
| Continental Illinois | 2,375 | 7.9 |
| Chemical Bank | 4,650 | 13.3 |
| Bankers Trust | 3,300 | 14.3 |
| First Chicago | 2,450 | 11.0 |
| First Interstate | 1,515 | 5.9 |

Source: Becker Paribas, Inc.

* *

San Diego is bracing for hysteria? Why? Its baseball team, the Padres, finally is going to make the playoffs. Ironically, its owner, Ray Kroc (founder and head of McDonalds) died last year and never lived to see his team triumph. My guess: Ray is cheering from "up there."

* *

You may have missed this (from the Wall Street Journal, Aug. 22) but I think it is one of the best explanations of the basic conflict between the US and Russia. And I think it also points to why the liberals in the US seem incapable of understanding the Russian stance. As matters stand, there will be no getting together with Russia, only a stand-off.

*Sir James Goldsmith, publisher of L'Express news magazine, Paris, to the Defense Strategy Forum of the National Strategy Information Center, Washington:*

There are lessons to be learned from the conflict between Carthage and Rome. The Carthaginians were a great Semitic people. When they needed to, they knew how to fight. Their greatest general, Hannibal, led his troops to victory in battles against Rome. But the Carthaginians were a mercantile civilization. They were traders and merchants, and they interpreted the motives of the Romans according to mercantile logic. Rome was different. Rome's purpose was military conquest and imperial expansion. This the Carthaginians were never able to understand, and so ultimately Carthage was destroyed.

Today in the West we are like Carthage and Moscow like Rome. We seem incapable of understanding Moscow's way of thinking. We are mercantile and want to conduct our affairs in peace. We try to set our policies on the premise that the Soviets want to do the same. Every time the Soviets embark on a new "peace" offensive, too many of us are pitifully eager to forget that this is no more than a modulation of Soviet tactics, not a change in their fundamental strategy.

Yet this should not be difficult for us to perceive. The 1977 Brezhnev constitution states quite officially that it is Soviet Russia's aim, indeed duty, to spread the Communist system to all countries of the world without exception. The Brezhnev Doctrine holds that once communism is established in a country, it becomes irreversible. The U.S.S.R. would use military means to intervene in any country where Communist rule is threatened. On the other hand, Communist rule must be established in non-Communist countries. To achieve this, the Soviet Union would support "wars of national liberation" by harnessing genuine local revolutionary forces and guiding them to Marxist-Leninism. The Brezhnev Doctrine means that the movement can only go one way.

Nonetheless, many of us still want to believe that the problems that separate us are problems that can be resolved by negotiation and mutual good will. But unfortunately we must realize that we cannot find lasting peace through negotiation because what the Soviets really want we cannot negotiate. We cannot cede to them the right to progressive imperial conquest. We cannot negotiate away our freedom. We must face the fact that the antagonism between our two civilizations is not superficial but fundamental and that we are condemned to this state of affairs for the long term. There is no easy solution, no quick fix. The only way to peace is by doing whatever is necessary for both sides to realize that war cannot be won.

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Michael Murphy (of the Esalen Institute at Big Sur) is back from living in Moscow. He states that the five contradictions of Soviet life are as follows: (1) No one works but everyone gets paid. (2) Everybody gets paid but you can't buy anything. (3) You can't buy anything but you can get anything. (4) You can get anything, but everyone is miserable. (5) Everyone is miserable, but everyone is for the system. (courtesy New York Magazine).

Murphy is a liberal, but I thought his comments on the Russians were interesting. Here are a few:

> Because nuclear-freeze and hands-across-the-sea groups are usually violently opposed to the defense buildup, it was surprising to me that Murphy was not.
>
> "When I first went to the Soviet Union, I was interested only in sports, and human potential. I found an enormous interest in the Soviet Union in these things, but I also found that everything quickly turns to politics. I don't pretend to be an expert. But many of our experts have their own filters and their own axes to grind. I do think the Russians understand a kind of toughness. I do think they will try to expand except where they are checked. I'm encouraged by the response we've been able to get in the Soviet Union, but they have the same trench psychology that we do, and they have some very tough and blunt characters in positions of authority."

* *

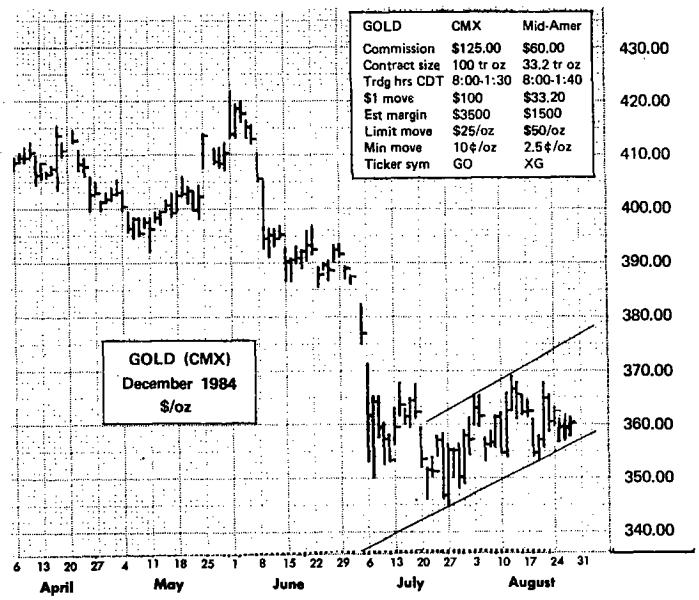
With the "new right" (the conservative wing) of the Republican party gaining increased strength, and the "old left" of the Democratic party (the flaming liberals) gaining increased strength , the political polarization is becoming more and more obvious to the voters. The danger of this split is seen by Morton Kondracke, executive editor of the New Republic. The paragraph below is worth studying carefully.

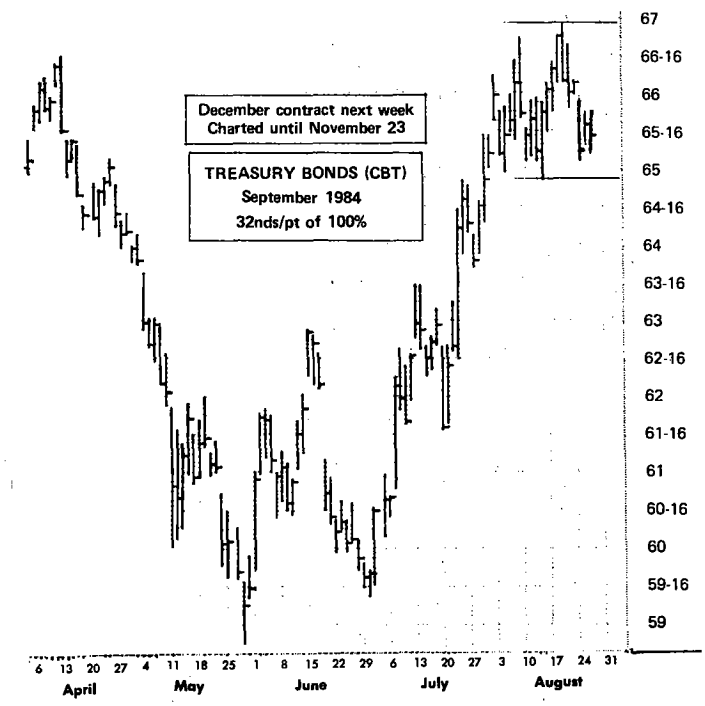
> A major problem for America, however, is that as the Republicans surge to the free-market and hardline-anti-Communist right, the Democrats are surging left, toward bureaucratized industrial policies, social quotas and withdrawal from world responsibilities. Beyond 1984, we seem due for a long, unpleasant period of polarization during which the parties will bash each other with conviction and prevent the country from getting anything done.

**BONDS, GOLD:** The redoubtable Henry Kaufman of Saloman Bros. Inc. believes that we have been seeing a rally in a bear market where bonds are concerned. Me, I plead ignorance. I honestly don't know whether this is a bear market rally in bonds–or the start of something a lot bigger. One thing is clear, however, and that is that the bonds are a bit exhausted on the upside, and they are now correcting. The accompanying chart (courtesy of Dunn & Hargitt) shows a top forming after the big run-up, and it would not surprise me to see the September bond futures contract break down to the 63 area. This would hardly be a disaster, but I would like to see the bonds hold roughly half their June-August gains, and that means that I would like to see the bonds hold above 62.5.

Trading bonds is difficult, and amateurs usually lose their shirts in the attempt. But buying bonds for return at today's fat yields levels makes sense. And there is one thing you know about a bond. It will give you par (1000) at maturity, assuming the company and the nation still stand when maturity comes around.

Gold is another story. Gold pays no return, but then gold will be around when all the bonds and all the politicians are long gone. In the last Letter I ventured that gold was forming a potential little bottom–but I said, don't bet on it. The "bottom" has been stringing out sideways, and I'm still not impressed with the gold action. Should December gold break out above 370, it should start filling the downside gaps back to 385. A price of 355 on Dec. gold would be discouraging, and anything under 345 (Dec.) would reconfirm the major bear trend in the yellow metal. My gold-to-common stock ratio remains bearish for gold.




**NEXT MAILING:** September 19